INDEX

	Page
Opinions below	1
Jurisdiction	2
Question presented	2
Statute involved	3
Statement	5
Argument	11
Conclusion	17

CITATIONS

Cases:

Anderson v. *Helvering*, 310 U. S. 404	12, 13
Bingham, Trust of v. *Commissioner*, 325 U. S. 365	16
Burnet v. *Harmel*, 287 U. S. 103	12, 13
Commissioner v. *Crawford*, 148 F. 2d 776	15
Commissioner v. *Felix Oil Co.*, 144 F. 2d 276	15
Kirby Petroleum Co. v. *Commissioner*, No. 56, this Term	15, 16
Palmer v. *Bender*, 287 U. S. 551	12, 13

Statutes:

Revenue Act of 1938, c. 289, 52 Stat. 447:

Sec. 22	3
Sec. 23	3
Sec. 117	4

Miscellaneous:

2 Summers, *The Law of Oil and Gas*, Sec. 284, *et seq.*	14

678677—46——1

In the Supreme Court of the United States

OCTOBER TERM, 1945

No. 667

WESLEY W. WEST, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

No. 668

J. MARION WEST, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

No. 669

ESTATE OF J. M. WEST, DECEASED, JAMES M. WEST, JR., ET AL., EXECUTORS, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

No. 670

JESSIE GERTRUDE WEST, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court and the dissenting opinions (R. 236–281) are reported in 3 T. C.

431. The opinion of the Circuit Court of Appeals, and the dissenting opinion of Judge Lee (R. 331–344) are reported in 150 F. 2d 723.

JURISDICTION

The judgments of the Circuit Court of Appeals were entered on July 24, 1945 (R. 344–346). A petition for rehearing (R. 349–353) was filed on September 8, 1945, pursuant to an order of the Court granting an extension of time for the filing of the petition (R. 348). The petition for rehearing was denied on September 18, 1945 (R. 353–354). The petition for a writ of certiorari was filed on December 15, 1945. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

The taxpayer made a transfer of mineral interests in a transaction pursuant to which the transferee undertook defined obligations with respect to the development and exploitation of the lands, the taxpayer receiving from the transferee a cash sum and retaining a royalty.

The question presented is whether the Circuit Court of Appeals erred in affirming the decision of the Tax Court that the cash so received is not taxable under the capital gains provisions (Section 117) but is taxable as ordinary income

under Section 22 (a) and subject to depletion under Section 23 (m) of the Revenue Act of 1938.

STATUTE INVOLVED

Revenue Act of 1938, c. 289, 52 Stat. 447:

SEC. 22. GROSS INCOME.

(a) *General definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case

in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each. (For percentage depletion allowable under this subsection, see section 114 (b), (3) and (4).

* * * * *

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) *Definitions.*—As used in this title—

* * * * *

(4) *Long-term capital gain.*—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held

for more than 18 months, if and to the extent such gain is taken into account in computing net income;

* * * * *

STATEMENT

This case involves the income tax liability of Wesley W. West for the calendar year 1938.[1] The facts as taken from the findings of the Tax Court and the stipulation of the parties (which was incorporated by the Tax Court as part of its findings (R. 259)), may be summarized as follows:

On December 28, 1938, the taxpayer, together with J. M. West, Jessie Gertrude West, J. Marion West, and the trustees of the West Foundation (hereinafter referred to as the Wests), transferred certain interests in lands situated in Texas to the Humble Oil and Refining Company, pursuant to a deed, assignment, and collateral agreement, all of which were executed simultaneously on that date (R. 30, 93, 238).

The deed covered some 23,155.60 acres of land (including a 200 acre homestead tract of J. M. West and wife, Jessie Gertrude West), together

[1] Proceedings determining the tax liabilities of Wesley W. West, J. Marion West, Estate of J. M. West, and Jessie Gertrude West, which arose out of the same transaction, were consolidated in the Tax Court (R. 236), in the Circuit Court of Appeals (R. 324–325), and in this Court (R. 356). For convenience, the Commissioner's brief in opposition will refer to only one taxpayer.

with the minerals only under 70.67 acres of other lands (R. 239). In the deed, the Wests "Granted, Bargained, Sold, and Conveyed" to Humble the described properties, "subject, however, to certain outstanding royalty interests, and to certain exceptions, terms, and provisions hereinafter referred to more specifically" (R. 36, 240).

Paragraphs A through G of the deed (R. 36–87) described the properties conveyed. Of these, paragraph G provided (R. 87):

> Also all oil, gas and other minerals produced from the land affected by this deed and produced subsequent to seven o'clock, A. M., December 28, 1938; subject, however, to the royalties hereinabove and hereinafter more specifically referred to, in so far as same apply to such oil, gas and/or other minerals.

The deed expressly excepted from the conveyance and retained to the grantors, their heirs, successors and assigns, certain royalties in accordance with the terms of the supplemental contract, which was expressly made a part of the deed for all purposes (R. 88).

The supplemental contract (R. 92–129) described the royalties excepted by the Wests and fixed upon Humble obligations with respect to exploitation and development. The royalties on oil ranged from $\frac{3}{16}$ to $\frac{3}{8}$, depending upon the depth from which it was produced and upon whether it was produced from the two known oil

fields on the land (the Friendswood oil field and the Clear Lake oil field) or from other portions of it. The royalties on gas were 1/6 on dry gas and 1/8 on casinghead gas, and that on other minerals was 3/16, except for sulphur upon which the royalty was $1.50 per long ton (R. 94–96). Section V of the agreement provided for the sale of the Wests' royalty oil to Humble at the prevailing market price, with an option in each of the Wests to terminate the purchase agreement as to his share at any time after five years (R. 106–108).

Humble's obligations to develop were defined in detail by Sections VII through X of the supplemental agreement (R. 109–117). It was required to operate at least two drilling rigs in the Friendswood and two in the Clear Lake oil fields until a producing well had been drilled for each twenty acres of the producing area, or to a greater density if necessary in order to offset wells drilled on other lands. In the event oil, gas, or other minerals were discovered in paying quantities on any portion of the land lying outside the two named oil fields (or in those fields at points below or above the existing production horizon) Humble was obligated reasonably to develop in those areas. It was further provided that after five years from the time when the Friendswood and Clear Lake oil fields had been developed to the described extent, the Wests could require Humble to drill one deep test well

678677—46——2

(limited to 10,000 feet) in each of five described areas.

Section XVIII of the agreement provided (R. 127–128):

> Humble is and shall be entitled to all oil, gas and other mineral produced from the property affected by said deed and assignment of even date herewith, produced subsequent to seven o'clock A. M., December 28th, 1938, subject to the royalties and overriding royalties hereinabove and in said deed and assignment specifically retained by First Parties. * * *

Section XIX provided for the arbitration of any disputed matter relating to the development of the properties, and Section XX provided that the terms and provisions of the contract were covenants running with the land (R. 128–129).

On December 28, 1938, Humble and the Wests executed a division order relating to one of the tracts involved to cover production above a depth of 7,500 feet. By this instrument, the parties certified and guaranteed that they were the sole owners of, and warranted title to, their respective interests in all oil produced (R. 256). The division order further provided that (R. 257):

> The oil run hereunder shall on the terms herein contained become the property of Humble Oil & Refining Company immediately upon being received into the possession of said Company. * * *

Similar division orders were executed by the parties covering oil and gas produced from other productive portions of the land conveyed to Humble (R. 257).

On December 28, 1938, there was on the land covered by the deed one oil well, one gas well and one well being drilled thereon (R. 256).

Prior to December 28, 1938, J. M. West got in touch with the president of Humble and told the latter that he wanted to sell the properties. Humble was interested in acquiring the right to develop and operate the lands for oil. Negotiations were handled for Humble by Barrow, its vice-president, and they continued over a period of several months. At various times Barrow tried to discuss with West the possibility of acquiring a lease instead of purchasing the surface in fee, but without success. The negotiations between West and Barrow culminated in the execution of the deed, the agreement and the assignment. Thereafter Humble leased back the surface of the lands and the residence to J. M. West for grazing and agricultural purposes for a period of five years at an annual rental of $16,000. This lease was renewed with a like rental with the residence excepted (R. 239–240).

Humble paid a cash sum for the interests which it acquired under the deed, assignment and supplemental contract and the parties have stipulated how much of the cash consideration was

allocable to the surface of the lands, and the improvements thereon, covered by the deed (R. 31–35, 257–259).

It is also agreed that all the properties referred to in the deed, together with the improvements thereon, had been held by the Wests for more than two years prior to December 28, 1938; and that the properties did not represent stock in trade or other property of a kind which would be included in the inventory if on hand at the close of the taxable year, or property held primarily for sale to customers in the ordinary course of trade or business, or property used in trade or business of a character which is subject to the allowance for depreciation, except for the improvements which were on the land at the time the transaction occurred (R. 30–31, 238).

In their returns for the year 1938, the Wests treated the transaction as effecting a sale to Humble of the mineral interests covered by the deed and reported a profit thereon as a long-term capital gain. The Commissioner ruled that the cash paid by Humble for the mineral interests was ordinary income subject to depletion and determined deficiencies accordingly (R. 258–259). The Tax Court sustained the Commissioner's determination (R. 236–275), Judges Murdock and Disney dissenting (R. 276–281). The Circuit

Court of Appeals, Judge Lee dissenting, affirmed the decision of the Tax Court (R. 331–344).

ARGUMENT

1. The decision below is correct in every respect and further review by this Court is not warranted. The Tax Court and the Circuit Court of Appeals each concluded that the transaction primarily looked to the exploitation of oil in whose production both the taxpayer and Humble had an interest (R. 273, 334), that the parties possessed the same fractional interest in the oil to be produced as would have been true if the conveyance had actually been cast in terms of a lease (R. 268, 333–334), that the form by which the conveyance was made did not constitute the sole or controlling factor (R. 272, 333–334), and that, whatever legal differences might ensue under local law on account of the fact that the exploitation rights were granted through the form of a sale rather than by a lease, those differences were not substantial enough to alter the tax consequences from those that would have followed if the transfer had actually been denominated a lease (R. 272–275, 333–336). Accordingly, it was decided that the cash payment received by the taxpayer did not represent proceeds from the sale of a capital asset which would be taxable as a capital gain, but that it was a cash bonus, paid as

advance royalties, and constituted ordinary income to the taxpayer which was subject to the allowance for depletion (R. 275, 334–336).

The decisions below embody the proper application of principles which have been established by this Court. In determining the tax consequences of the transaction, the courts below rightfully disregarded the form that the particular instrument of transfer took, or its effect, under state law, respecting title to the oil in place. *Burnet* v. *Harmel,* 287 U. S. 103; *Palmer* v. *Bender,* 287 U. S. 551; *Anderson* v. *Helvering,* 310 U. S. 404, 411. Under *Burnet* v. *Harmel, supra,* it is manifest that the cash payment received was ordinary income to the taxpayer regardless of the fact that Humble may have acquired legal title under local law to a fractional portion of the oil in place, and regardless of the formal attributes of the instrument by which that was accomplished.

The taxpayer seeks to avoid the application of *Burnet* v. *Harmel, supra,* by emphasizing certain alleged differences between an ordinary leasing agreement and the instruments involved here (Br. 8–13). However, even if such differences do exist, they are demonstrably immaterial. The fact that the taxpayer may not have retained a reversionary interest in the fractional portion of the oil granted to Humble has no controlling significance (Cf. Br. 10–13). The rule of *Burnet* v. *Harmel, supra,* was expressly followed in *Palmer* v. *Bender, supra,* where the Court rejected the

contention that, despite the retention of an interest in production, a cash payment constituted the proceeds of a sale because the taxpayer did not retain a reversionary interest under state law. Instead, the Court held that, irrespective of the absence of a reversionary interest, and without regard to the fact that a lessor-lessee relationship might be lacking, the receipt of a cash payment upon the transfer of an interest in production was not the proceeds from the sale of a capital asset if the transferor also retained a continuing interest in production. Although the instrument in that case took the form of an assignment of a lease, while here it is in terms of a sale which, allegedly, transferred title to a fractional portion of the underlying oil, the cases are not to be distinguished on that account. *Burnet* v. *Harmel, supra; Palmer* v. *Bender, supra*; *Anderson* v. *Helvering, supra.*

It is not significant, either (cf. Br. 10–12), that Humble's right to produce was not limited in time, as would be true in the case of an ordinary lessee, and that Humble may have acquired all of the extraction rights formerly possessed by the taxpayer in the fractional portion of the oil transferred. The decision in *Palmer* v. *Bender, supra,* demonstrates that the distinction urged has no material bearing on the problem for there, too, the transferee's rights extended as long as the transferor's, and the transferee acquired all the rights which the transferor formerly possessed in

the fractional interest conveyed. It is true that in that case, upon the expiration of the original lease, the rights of both the transferor and the transferee would terminate, while here the rights of both parties are indefinite; the important factor, however, is that in both cases the transferor has retained, by way of a royalty, a continuing fractional interest in production.

There are, moreover, no practical economic differences between a lease, with the retention of a royalty interest, and an assignment or sale, with the retention of a royalty interest. Cf. Br. 10–12. The usual lease extends for as long as oil and gas may be produced in paying quantities. See 2 Summers, *The Law of Oil and Gas,* Section 284, *et seq.* Thus, a lessee, as a practical matter, may extract all the underlying oil, or may continue to do so until extraction is no longer practicable or profitable. If it be true that, in this case, Humble has acquired the abstract right to continue extraction after the reserves have been exhausted or have become depleted beyond the point where production would no longer be feasible, and that in the case of a lease, the taxpayer would have retained the right to do so, the difference seems only theoretical. It should be only too apparent that where the decision must turn on the question of who has an economic interest in the underlying oil, the result should not depend upon the presence or absence of the right to extract

nonexistent deposits or the right to produce where production is no longer practicable.

It is submitted that if the court below had arrived at any other conclusion, its decision would have been an invitation to skillful conveyancers to discard the usual terms of a lease and to devise new forms to achieve desired tax results, without altering the material relationships that exist in the ordinary leasing agreement.

2. There is no conflict in decisions. While the taxpayer (Pet. 9–11) asserts that the present case is opposed, in principle, to the decisions of the Circuit Court of Appeals for the Ninth Circuit in *Commissioner* v. *Felix Oil Co.,* 144 F. 2d 276, and in *Commissioner* v. *Crawford,* 148 F. 2d 776 (pending in this Court, No. 197, along with *Kirby Petroleum Co.* v. *Commissioner,* No. 56, October Term, 1945), the issues and principles presented are altogether different. The problem presented in these cases is now before this Court, and the only issue in this Court, as in the circuit courts of appeals, is whether the net profit payments received by a lessor, who has also retained a royalty interest, constitute income from the production of oil and are depletable. Accordingly, even if this Court, in resolving the conflict between the *Crawford* and *Kirby* cases, *supra,* should agree with the Circuit Court of Appeals for the Ninth Circuit that the net profit payments are subject to the depletion allowance, it is difficult

to envisage how the decision could conflict with that of the court below.

There is, moreover, no warrant for the taxpayer's suggestion (Br. 14) that the Commissioner's position in the present case differs from that expressed in the net profit cases. The Commissioner contends that there has not been a sale of a capital asset in either situation. In the present case, there has been no sale because the cash payment received was in the nature of advance royalties which are taxable as ordinary income. In the net profit cases, the payments are not depletable because they do not constitute "gross income from the property", but, nevertheless, they are payments of ordinary income and there has been no sale of a capital asset. See Commissioner's brief in the *Kirby* case, *supra,* pages 25–27.

The taxpayer also contends (Pet. 12–13) that the decision below is opposed to *Trust of Bingham* v. *Commissioner,* 325 U. S. 365. The assertion of this conflict is made despite the taxpayer's frank admission that (Br. 17):

> It is somewhat difficult to ascertain from a reading of the Circuit Court's opinion the extent to which it thought itself bound by the conclusion of the Tax Court that the transaction did not constitute a sale within the meaning of Section 117 of the Revenue Act of 1938. * * *

Since the Circuit Court of Appeals referred to the *Bingham* case (R. 336), it is clear that it was

fully aware of the latest pronouncement of this Court respecting the extent to which the Tax Court's decisions must be accorded finality.

We believe that it is not necessary to discuss the finality of the Tax Court's conclusions in the present case. For, even if we should agree with the taxpayer that the question whether a sale occurred was not one on which the Tax Court was the final arbiter (Br. 17–18), the opinion below unmistakably shows that the Circuit Court of Appeals did not misunderstand the limits of its jurisdiction. The court clearly exercised its independent judgment in deciding that, under the statute and the applicable decisions of this Court, the taxpayer did not make a sale of a capital asset.

CONCLUSION

For the reasons expressed above, the petition for a writ of certiorari should be denied.

Respectfully submitted.

J. HOWARD MCGRATH,
Solicitor General.

SEWALL KEY,
A. F. PRESCOTT,
HILBERT P. ZARKY,
Special Assistants to the Attorney General.

JANUARY 1946.

U. S. GOVERNMENT PRINTING OFFICE: 1946